Vietnam's Flirtation with Development

By David Dapice

Vietnam is a country of 80 million literate and hard-working people, in the middle of the fastest-growing region of the world. It has nearly the land area of Germany, a solid agricultural base, reasonable reserves of oil and gas – and one of the lowest living standards in the world. Measured in terms of purchasing power, Vietnam's per capita income is just 6 percent of that of the United States.

Yet during the 1990s, Vietnam was also one of the fastest-growing countries in the world. Plausible estimates suggest that poverty may well have fallen in half from 1988 to 1998 while incomes doubled, and the improvement of its rural sector since 1990 is little short of revolutionary. Exports tripled from 1993 to 1998, and grew by a quarter in the first six months of this year over last.

In spite of this recent success, though, Vietnam's prospects are deeply clouded. Many observers are predicting sluggish growth, due to falling foreign investment, slow utilization of aid, a weak private sector and an inefficient state sector. In short, Vietnam has managed to trans-

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form itself from a centrally planned economy that was facing hunger and hyperinflation in the middle 1980s, but has stopped well short of the changes needed to ensure its entry into the club of developed economies. It is treading a singular path that few outsiders believe will lead to economic success or social harmony. Much now depends on its will to regain reform momentum.

HOW THEY GOT THERE

To understand Vietnam today, go back to the end of North Vietnam's war with the Americans. When North Vietnam and South Vietnam were united at the end of that war, the divergent historical experiences of the two nations guaranteed a rocky start. The people in the south, even those who welcomed the fall of the South Vietnamese government, were accustomed to a market economy. There had been effective land reform in the early 1970s in the Mekong Delta, creating a landed peasantry in the rice bowl of the country. So when the government tried to apply central planning to agriculture, there was passive resistance and production stagnated.

This went on for several years. And with the war with the Khmer Rouge raging in Cambodia and the Khmer Rouge's ally, China, threatening Vietnam in the north, the government was in no position to crack down. But the rural reforms were undercut after the immediate crisis subsided. This led to food shortages (in spite of aid from the Soviet Union) and then, with rapid money creation, to hyperinflation in the mid-1980s.

That object lesson was not lost on Hanoi. In addition, its close links with the Soviet Union let the Vietnamese see the implications of Mikhail Gorbachev's *glasnost* and *perestroika.* The Soviet Union, Vietnam's main patron and trade partner, was changing, and they, too, had to change or face the consequences.

REFORMS, A.K.A. *DOI MOI*

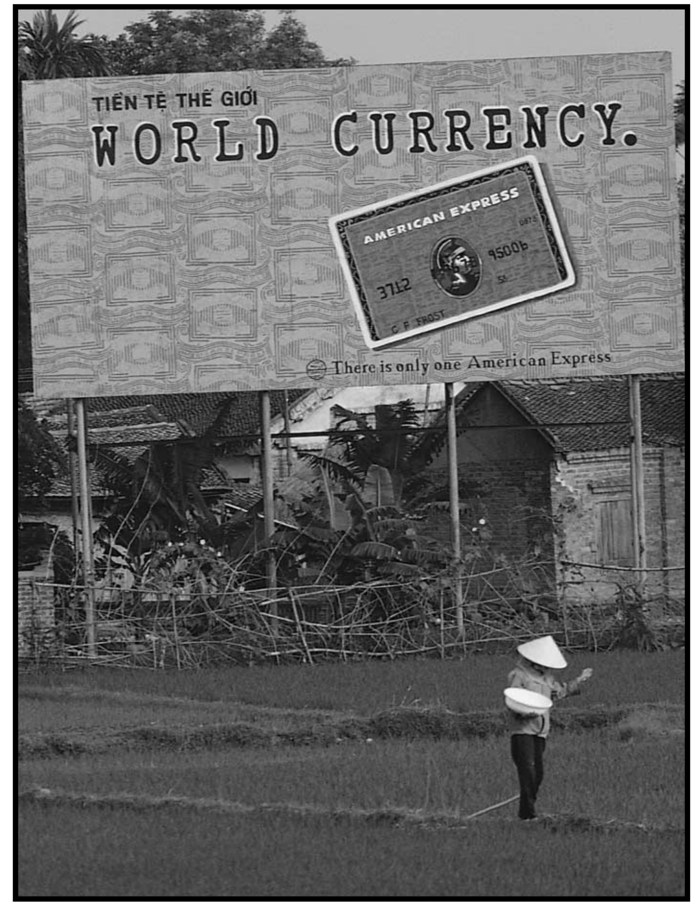
The denouement was a debate within the leadership that led to *doi moi*, the homegrown reform program that aimed to maintain a socialist (read single-party) political system while moving towards an economy that used market forces to a greater degree to determine prices and output. The resulting changes were sweeping. Farm families got their own land and were more or less free to plant what they wanted. They could also sell to whomever they wanted – though the government continued to monopolize export markets, so prices were still effectively controlled.

The government gradually got a grip on the printing presses at the mint, and inflation subsided. Interest rates rose above the inflation rate, though the banking system remained dominated by state-owned banks that lent mainly to troubled state enterprises. Foreign-investment laws were liberalized and, after 1990, a huge amount of investment commitments were made – a volume of commitments exceeding the annual GDP.

Yet, government promises didn't quite match the reality. Investors found it difficult to operate businesses and relatively little – a third or less – of the licensed investment was actually converted to capital on the ground.

The period after the fall of the Soviet Union was an exciting and interesting one. Though there was an initial lurch towards the political reaction, the rapid progress in the economy created a climate in which new ideas could be considered. And there was significant movement toward reform – though, paradoxically, this impulse slowed after 1994, when the United States lifted its veto against loans from multilateral donors and more Western aid flowed into the country.

Along with the modest export revenues realized from growing oil production, these funds allowed the government to avoid tough decisions while still maintaining an 8 to 9 percent rate of economic growth. A 1998 World Bank study shows policy reform slowing and then virtually stopping as aid rose in the early- and middle-1990s. So long as old habits could be followed with such success, it did not seem very urgent to change them.



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THE RISING TIDE

The years from 1990 to 1998 were a period of continuous growth in all sectors. Numbers can be wearying, but the gains were too spectacular to gloss over.

Rice production rose 52 percent, to 29 million tons in 1998. Coffee output rose 537 percent, to 409,00 tons, in the same period, making Vietnam the world's largest exporter of the *robusta* varietal used in instant coffee. Sugar cane production rose 152 percent – though only by the inefficient device of pegging the domestic sugar price at twice the world free market price. Rubber, tea, seafood and livestock all showed impressive growth.

Rural deregulation has created a dynamic farm sector that is still growing. Because most people live in rural areas, a 4 percent annual gain in farm output translated into broad-based gains in income. Yet many of the gains from deregulation have already been realized. With 80 million Vietnamese crowded into the rural economy, there is less than an acre of land per farmer. Agriculture is thus a good base, but it cannot make the country rich.

Happily, industry recorded even more impressive growth. Electricity production grew 12 percent a year, nearly tripling in the decade. Cement output quadrupled. Light manufactured exports grew nearly tenfold, to about $4 billion in 1999.

The story in industry is a complicated one, though. Export-oriented industry, much of it based on foreign investment, was fast-growing and efficient. However, it generally was built around using Vietnamese labor to process semi-finished imports, and thus value-added was usually only 15 percent to 20 percent of the export value. Out of industrial GDP output of nearly $10 billion in 1999, perhaps 8 percent of value-added was from

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manufactured exports. Little of the industrial foreign direct investment went into this export sector – certainly less than a quarter.

Foreign direct investment also funded many joint ventures, mainly with state enterprises that sought to replace imports. Their goods tended to to be heavily protected against foreign competition. As in many other nations that have followed this path, the import substitutes were priced high and could not easily be exported into global markets. The output of the joint ventures also quickly exceeded domestic demand, since they were forced to price high to cover costs. This led to attempts to fill the demand gap with public spending, but such policies were merely stopgaps. Indeed, it led to grotesque waste, such as the construction of a dozen car factories that in total produced 5,000 vehicles a year – less than 1 percent of their capacity.

About three-quarters of industrial foreign direct investment fell into this wasteful category. However, there is hope that some of these joint ventures will be able to lower costs and become competitive. This will be necessary if Vietnam is to meet its commitments to lower trade barriers in joining the ASEAN Free Trade area in the next few years.

The ownership structure of the new industry evolved curiously. In 1990, more than 60 percent of all industrial output came from state enterprises; by 1999, this figure had fallen to 44 percent. The foreign sector, including joint ventures, grew very quickly and rose from almost nothing to 32 percent of all industry within the decade. The balance, coming from domestic private industrial enterprises, declined from a third to just over a fifth of output.

Think for a moment what this means. During a decade of rapid growth following liberalization, the domestic private industrial sector lost ground, as did the state sector! The de facto strategy was to rely on foreign investment, nominally in joint ventures, for most of the industrial growth.

With the recent fall-off in foreign investment, this trend has been reversed. In the first quarter of 2000, private domestic industry grew the fastest and foreign industry the slowest. However, this may be partly due to unusual factors like falling oil output (a foreign-sector activity) and better coverage of existing private producers in the data.

The Alice-in-Wonderland quality of the current policy is exemplified by one official who said, "The private sector should have a level playing field so long as the state sector plays a leading role." Of course, the foreign sector has been leading, though it is faltering, and the private domestic sector is remarkably small and weak. If state enterprises must lead, it will be a slow advance, indeed.

The service sector is perhaps the hardest to reform. The state telephone monopoly, for example, make rates in Vietnam among the highest in the world. The price of international calling is particularly startling: a call to the United States costs more than $3 a minute, many times more than transpacific calls from other countries in the region. Though not a monopoly, Internet connections are expensive and slow to the point of being useless. Electricity blackouts are not uncommon, and, in spite of an agreement with the World Bank five years ago, there has been almost no progress in allowing private operators to build generating capacity.

State banks, which dominate the banking sector, do not do a good job of providing financial services to private firms. At the end of 1998, private industrial and rural credits equalled $2.5 billion, less than 10 percent of GDP, compared to 40 percent of GDP in Indonesia. Various restrictions hobble the foreign banks that do have offices, and few are profitable. There is no domestic corporate bond market to speak of, although a limited form of stock market may finally appear this summer after years of delay.

State enterprises still dominate international trade, though larger private firms can now trade directly for their own imports and exports. Overall, regulation, monopoly and special interest protection leave Vietnam well behind many of its neighbors. Even when the official policy is fair, implementation is flawed. Vietnam ranks fourth from the bottom of Asian countries with respect to corruption, and dead last on transparency. This raises costs for both domestic and foreign-managed firms.

One might have expected the growth of the 1990s to have been concentrated on a few favored localities. After all, the areas in and around Hanoi get 30 percent of all foreign direct investment, while Ho Chi Minh City and three nearby provinces get nearly half of the foreign investment. Most manufactured exports and industry come from the South, and these have grown the fastest. Yet, as the table shows, the gains of the last decade were still spread fairly widely.

The middle-income regions (the Mekong Delta and the Central Coast) had the least decline in poverty; these regions still had more than a third of their population living in poverty in 1998. The poorest regions generally saw larger declines in poverty, but still must cope with half their people in poverty. The Red River Delta, the area around Hanoi, had the largest decline in poverty, while Ho Chi Minh City (once, Saigon) enjoyed income gains that reduced poverty to just 8 percent.

This reflects the economic activity in that

INCIDENCE OF POVERTY BY REGION IN VIETNAM, 1993 AND 1998

REGION	POPULATION (MILLIONS)	POVERTY 1993 (PERCENT)	POVERTY 1998 (PERCENT)	PER CAPITA INCOME 1998 ($)	REAL PER CAPITA INCOME GROWTH 1993-1998 (PERCENT)
Northern Upland	13.5	79	59	1,921	31
Red River Delta	14.9	63	29	2,710	55
North Central	10.5	75	48	2,030	46
Central Coast	8.1	50	35	2,440	29
Central Highlands	2.8	70	52	1,790	25
Southeast (HCM City)	9.7	33	8	4,663	78
Mekong Delta	16.3	47	37	2,350	18

Income calculated at an exchange rate of VD13,000 =$1.

SOURCE: Vietnam: Attacking Poverty, Joint Report of the Government-Donor-NGO Working Group, 1999.

market-oriented city, as well as the considerable remittances from relatives overseas. Estimates of those gifts range from $1 billion to $2.5 billion a year – $100 to $250 for each person in the region.

Vietnam did well by other socioeconomic measures, too. Reductions in restrictions on movements of labor, the great jump in food availability and the taming of inflation all helped improve conditions. Primary education is now almost universal, while the percentage of children going to secondary school doubled between 1993 and 1998, to 60 percent. Most Vietnamese put a high value on education, and higher private incomes have helped ensure that more children are able to stay in school and to afford the costs of books, uniforms and tutoring.

The rate of mortality by age five, which had been more than 10 percent in the 1980s, had fallen to 4 percent by 1997. Thus, while Vietnam remains poor by virtually any yardstick, the last decade has been one of striking and widely based economic and social progress.

BUBBLES, CRISES AND BOTCHED TRADE DEALS

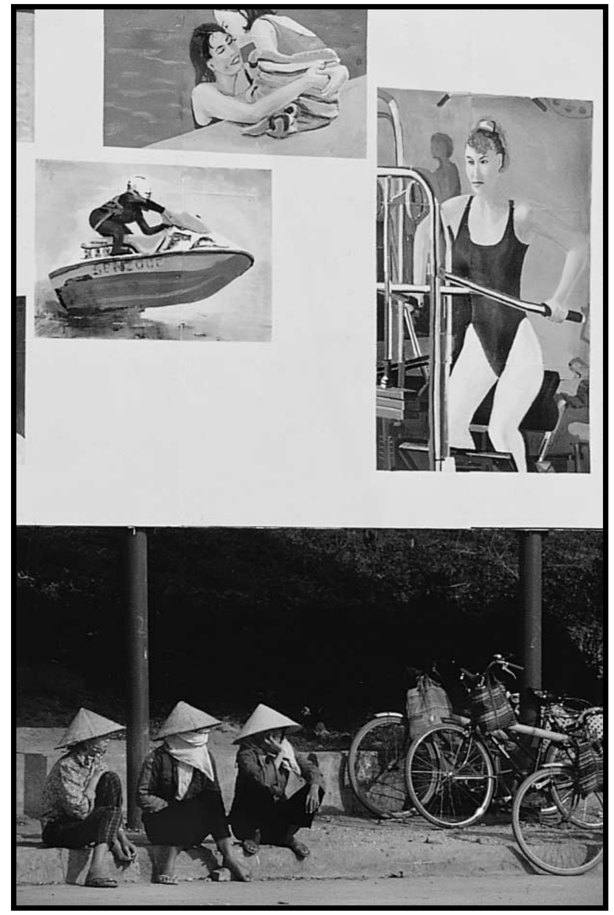
The flood of capital that washed into China, Thailand, Indonesia and Malaysia from 1993 to 1997 also lapped ashore in Vietnam. Many investors came with more enthusiasm than sophistication about making capital productive in pre-capitalist economies. And as the initial jolt from their funds lifted the growth rate, the belief of Vietnam's ruling conservatives that not much institutional change would be necessary was reinforced. It appeared that Vietnam could insist on cumbersome joint ventures, impose high costs of services and restrict hiring. Vietnam had been important during its wars, so why shouldn't it be attractive in peace?

The government was even able to avoid releasing reliable economic data, without any severe impact on investor interest. In spite of billions in aid from the World Bank and the International Monetary Fund, Vietnam stands almost alone in the world in not having a page of economic data in the IMF's monthly publication.

The crisis in Asia affected Vietnam's attitude toward foreign investment as much as it affected foreign investors' attitudes toward Vietnam. Just as some older United States stock market investors treat every downturn in the Nasdaq as the final, inevitable bursting of an irrational bubble, so some socialists believed that the prosperity of much of Asia was unstable. They distrusted the market and the volatility it brought.

Since their richer capitalist neighbors collapsed and China did not, they decided that it was safer to keep some distance from the global economy. This meant not only maintaining an unconvertible currency, but also hanging on to state enterprises and the tightly regulated banks that funneled resources into them. By the same token, public monopolies would not be abandoned. Their view is not confined to socialists alone: Dr. Mahatir Mohamad, Malaysia's capitalist-baiting strongman, is a very popular figure in some Vietnamese circles.

This worldview led to one of the most bizarre decisions by any Asian economy in recent years: the rejection of a bilateral trade agreement with the United States. After straining for years to hammer out a bilateral trade deal, the governments announced success in the summer of 1999. Both sides had made compromises. All in all, the bilateral trade agreement was very similar to the one the Chinese signed later in 1999, but had longer adjustment periods. Vietnam was give seven years to open banking and telephone services to foreign competition. The deal would have lowered United States tariffs on Vietnamese manufactured goods; Vietnamese exporters are now stuck paying prohibitive rates left over from the Depression era. One estimate suggested the pact would generate an $800 million gain in exports to the United States in the first year, with much larger gains over time as the export economy expanded.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Although Vietnam's manufactured exports have grown very rapidly, they expanded from a very low base. In 1999, they had reached a level of $4 billion. In contrast, the manufactured exports of the sluggish Philippine economy grew by $4 billion *annually* in recent years. There is no doubt that further export growth would have provided badly needed jobs, foreign exchange and technology.

However, in the wake of the Asian crisis, conservatives in Vietnam were able to retract approval of the trade deal. Many in the state enterprises worried about their viability if they had to compete with lower tariffs and fewer friendly banks. There were ideological and security concerns, too, especially about losing control of communications. All this was fed by a general distrust of Americans in response to lingering anti-Vietnamese feelings in the United States.

Besides strong anti-Communist feelings among many Viet-Kieu (overseas Vietnamese), there is Radio Free Asia, a United States government funded propaganda station that broadcasts in Vietnamese and takes a generally anti-government line. It is normally jammed and is resented as unfriendly. What's more, periodic statements by American politicians feed the perception of hostility. Even Senator John McCain, who has probably done more for Vietnam and for United States-Vietnamese relations than almost anyone in the Congress, was recently in Vietnam and quoted as saying, "The wrong side won." Perhaps, then, it should not be surprising that only in the last month has a political coalition favoring closer ties to America been able to push through the free-trade pact.

Growth in 1998 and 1999 fell to about half the level of the 1990-97 period. Foreign investment is quite low now, in spite of various regulatory adjustments that have made it easier to invest. The lack of access to United States markets, a glutted domestic market, poor profits, corruption and lack of government transparency have given Vietnam a bad reputation. Many firms are leaving or scaling down their activities. Some export-oriented investments are still coming into the South, but Nike is reconsidering its commitment to producing shoes in Vietnam. Nike's departure would knock out 50,000 badly needed jobs, and cast an even deeper pall over foreign investment.

Exports of manufactures are still growing, but it's far from clear that the growth is sustainable. The current strategy is to rely on preferences for garment exports to the European Union. It will probably take some experience with a real slowdown before the message sinks in that the decision to turn down a bilateral trade deal with the United States was at best, a setback.

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Assuming the just-announced trade deal goes through, Vietnam will have a shot at catching up to its neighbors, which drew the opposite conclusions from the Asian financial crisis and are allowing, even encouraging, more foreign investment, and moving toward greater transparency and global integration. But in a world moving at electronic speed, the decision-making process in Vietnam remains deliberate.

It is hard to accept that the world has changed and one's own position in it has diminished. Yet that is the case for Vietnam. What was a focal point in the Cold War could become a backwater. Its economic size is tiny, with both GDP and exports behind that of New Zealand. Good, cheap labor is useful, but can be found elsewhere.

Yet the government continues to pour money into politically useful but economically questionable state-owned ports, refineries and bridges while few loans go to private industry. The world has moved on, and even traditional donors such as the Japanese seem to be losing patience with the stalled reforms. Certainly, few foreign investors still have Vietnam on their radarscopes. Actual gross foreign investment in 1999 was about $600 million, compared to 1996 commitments of $8.6 billion and cumulative approvals of more than $30 billion.

If the foreign sector is losing interest, the state sector is moving slowly. Its accumulated debts of $14 billion in 1999 amounted to half of GDP. Few of the 5,300 state-owned enterprises want to privatize, or move toward a joint-stockholding structure, in spite of a policy directive to do so. About 7 percent have made the jump, but most of these are small and many were losing money when they were forced to change their status.

Results of these forced changes have been mixed. The state sector, including all levels of government, as well as the state enterprises, is adding fewer than 80,000 workers a year. Yet the labor force is growing by 1.2 million annually. If Hanoi tries to put the burden of industrialization on the state enterprises, there will be few jobs and little industry because structural inefficiencies limit their profit potential. The government budget would scarcely be able to support the added demand for cash. With Vietnam's credit rating at a dreary B1 level, access to nonconcessionary loans will be limited.

This leaves the burden of development on the domestic private sector. While small business is allowed, growth beyond a few dozen employees often brings unwanted attention from the authorities. Many larger private employers still do not use banks. Some avoid building a central factory, so that they can spread out their activities and keep a low profile. While recent rhetoric has emphasized the need for the private sector and some bureaucrats have taken it to heart, it will take some time to see if this is another zig before another zag, or a real change in direction.

Passage of the Enterprise Law in January 2000 secured rights to run private businesses, and thousands of new firms have sprung up. Private domestic output is up a startling 17 percent in the first five months of this year, though some of this growth may come from firms that already existed but decided it was a good time to register. Note, in any case, that growth starts from a low base. There were only 465 private industrial firms with more than 100 workers, according to a 1998 survey. Vietnam's 5,620 registered private manufacturing firms employed 264,000 workers, just 7 percent of all industrial employment.

PROSPECTS

As Yogi Berra once said, it is hard to predict, especially about the future. Poor nations have a capacity to grow faster than rich ones because they can build on the shoulders of foreign technology and foreign demand. Besides, Vietnam has the capacity to surprise – and also to do better than it should.

It is likely that some southern provinces will manage to keep growing because they have adopted a business-friendly stance and because there are still a lot of export opportunities left for Vietnam in Asia and Europe. Yet in a country of 80 million with dysfunctional banks, limited foreign investment, poorly used aid and no other meaningful capital markets, it is hard to see how Vietnam will compete with China or neighboring ASEAN countries. China, with permanent normal trade status and World Trade Organization membership, will attract more efficiency-inducing foreign investment. Meanwhile, the ASEAN market economies are reforming and will have low tariff entry into Vietnam by 2005. Vietnam's borders are porous in any case: electronics, motorcycles and even foreign sugar (which is far cheaper than the protected domestic crop) are smuggled into the country.

The rural sector can keep growing, but not as fast as in the past decade. Rapid growth in the service sector will rely on deregulation, and that is coming very slowly. The industrial sector will need a change in policy to avoid a dead-end reliance on high-cost industries. Public investments tend to follow a political rather than economic logic, and the accumulating debts will not be easy to service in the medium run.

That said, growth this year will probably be about 6 percent, largely due to higher crude oil prices and rapidly expanding public spending. There is no crisis looming, just a prospect of slowing growth over time.

The best thing going for the Vietnamese is their pragmatism. If they can gain the vision to see their own self-interest, they will succeed. Vietnam's hidden tangible asset is the relatively small size of the state sector and of the banking system, which will make the cost of transition to markets modest in comparison to China. Laying off just 1 percent of the work force and spending 2 to 4 percent of GDP for bank bailouts would be enough to start afresh.

Just as in the past, the Vietnamese will make their own decisions, on their own schedule. One can only hope they manage to increase the tempo, for the world is no longer waiting.